



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Draft

Date Introduced:	02/22/07	Bill No:	AB 846
Tax:	Sales and Use	Author:	Blakeslee and Karnette
Related Bills:	AB 307 (Hayashi) AB 493 (Ruskin) AB 1190 (Horton & Huffman) SB 74 (Florez)		

BILL SUMMARY

Among other things, this bill would establish the Clean Marine Fuels Tax Incentive Act to provide a sales and use tax exemption for low-sulfur fuel products sold to water common carriers and used in either the vessel's auxiliary or main engine, under specified conditions.

ANALYSIS

CURRENT LAW

Under current Section 6385 of the Sales and Use Tax Law, sales of fuel and petroleum products to water common carriers, for immediate shipment outside this state, are exempt from tax when used in the conduct of the common carrier's activities after the first out-of-state destination. The exemption for bunker fuel purchased by qualified waterborne vessels is dependent upon the amount of bunker fuel on board the vessel prior to refueling. If the quantity of bunker fuel on board the vessel on arrival at the California port is sufficient to enable the vessel to reach its first out-of-state destination, then the bunker fuel loaded at the California port is entirely exempt from tax. However, if the quantity of bunker fuel needed on the voyage from the California port to the first out-of-state destination and the amount used while in port exceeded the quantity of fuel on board the vessel on arrival at the California port, the amount of that excess is subject to tax.

PROPOSED LAW

This bill would add Section 6357.7 to the Sales and Use Tax Law to exempt from the sales and use tax the sale of low-sulfur fuel products to a water common carrier inside this state for use in a vessel's auxiliary engine for immediate consumption or shipment in the conduct of its business as a water common carrier operating in California territorial or internal waters. This section would provide the following definitions:

- Low-sulfur fuel is any fuel, including heavy fuel oil (HFO), marine distillate fuels, marine gas oil (MGO), marine diesel oil (MDO), or any other diesel fuel with a sulfur content no greater than 0.05 percent or 500 parts per million. The fuel is further defined by how it is used. The fuel may only be used in the operation of an engine, on a vessel, that provides power for use other than propulsion.

- “Immediate consumption or shipment” means that the delivery of the low-sulfur fuel products for use in a vessel’s auxiliary engine by the seller is directly into a vessel for consumption by that vessel while in California territorial or internal waters, and is not used for storage by the purchaser or any third party.
- “Territorial or internal waters” means waters within a seaward boundary three geographical miles into the Pacific Ocean measured from the mean low-water mark of the California coast, all interior navigable waterways, and the Monterey Bay, subject to definitions of the United Nations Convention on the Law of the Sea.

In addition, this bill would add Section 6357.8 to provide a sales and use tax exemption for sales of “low-sulfur fuel products for use in a vessel’s main engine” sold to a water common carrier for immediate consumption or shipment in the conduct of its business as a water common carrier until the lesser of the first out-of-state destination or 500 nautical miles beyond California’s territorial waters. This section would provide the following definitions:

- Low-sulfur fuel means any fuel, including HFO, marine distillate fuels, MGO, MDO, or any other diesel fuel with a sulfur content no greater than 1.5 percent or 15,000 ppm. The fuel is further defined by how it is used. The fuel may only be used in the operation of an engine, on a vessel, that provides power for propulsion.
- “Immediate consumption or shipment” means that the delivery of the low-sulfur fuel products for use in a vessel’s main engine by the seller is directly into a vessel for consumption by that vessel alone until the first out-of-state destination or 500 miles beyond California’s territorial waters and not used for storage by the purchaser or any third party.
- “Territorial waters” means waters within a seaward boundary three geographical miles into the Pacific Ocean measured from the mean low-water mark of the California coast, and the Monterey Bay, subject to definitions of the United Nations Convention on the Law of the Sea.

This bill also amends Section 6385 so that the existing repeal date is dependent on changes in federal statutes, and otherwise makes permanent the sales tax exemption of fuel and petroleum products to a water common carrier for immediate shipment outside this state when used in the conduct of the common carrier’s activities after the first out-of-state destination. Section 6357.7 is repealed when low-sulfur fuel sales made inside this state to water common carriers for use in a vessel’s auxiliary engine accounts for greater than 95% of all sales of marine fuels to water common carriers used in such a manner. If the U.S. Environmental Protection Agency (EPA) sets standards for all foreign flagged and domestic ships limiting sulfur emissions in California waters, then Section 6357.8 is repealed six months from the date the Board submits this information to the Legislature and the Office of Administrative Law.

Section 60510 would be added to the Diesel Fuel Tax Law (Part 31 (commencing with Section 60001) of Division 2 of the Revenue and Taxation Code), which would affect the refund and overpayment provisions. As provided, any claim for refund made pursuant to Section 60501 where the diesel fuel was sold and delivered directly to an ultimate purchaser by an ultimate vendor, the diesel fuel sold has a sulfur content of greater than 0.5 percent, or 5,000 parts per million, and the diesel fuel was used for purposes other

than operating motor vehicles upon the public highways of the state, the refund amount would be reduced by an amount equal to:

- Twenty-five percent of the claim, for all claims made after the effective date of this section and prior to January 1, 2010.
- Fifty percent of the claim, for all claims made on or after January 1, 2010, and prior to January 1, 2012.
- Seventy-five percent of the claim, for all claims made on or after January 1, 2012.

This bill would go into immediate effect, but the provisions of this bill would become operative on the first day of the first calendar quarter commencing more than 90 days after the effective date.

BACKGROUND

The LAO issued a report in 2002 on the effect of the bunker fuel exemption, and concluded “On this tax policy basis, we recommend that the Legislature remove the existing sunset for the current partial (sales and use tax) exemption for bunker fuel sales, and make the exemption permanent. This would result in the (sales and use tax) being levied in the future only on the portion of the fuel purchased in California which is consumed between California and the first out-of-state destination. This action would result in treating bunker fuel sales similarly to other export sales and place California ports on par with other U.S. out-of-state ports.” The Pacific Merchant Shipping Association (PMSA) sponsored Senate Bill 145 (Perata) during the 2002 Legislative Session to extend the sunset date for the bunker fuel exemption until January 1, 2013. SB 145 passed the Legislature, but was vetoed by the Governor. As a result of the Governor's veto of SB 145, the sales and use tax exemption for sales of bunker fuel sunset as of January 1, 2003.

SB 808 (Ch. 712, Stats. 2003), which was authored by then Senator Karnette and sponsored by the PMSA and the International Long Shore Workers Union, reinstated the sales and use tax exemption for bunker fuel sold to water common carriers. The Legislature found and declared that in addition to the negative economic impact of not having a sales tax exemption, there was also a health impact related to the increased production of petroleum coke, which is an alternative refining product to bunker fuel.

COMMENTS

- 1. Sponsor and Purpose.** According to the author's office, this bill is sponsored by the PMSA. The purpose of this bill is to provide an incentive for oceangoing vessels to use cleaner marine fuels.
- 2. What kind of engines and fuel types does the industry use now?** According to a 2005 California Air Resources Board report¹, most oceangoing vessels use a single large slow-speed diesel engine for propulsion, and smaller medium-speed auxiliary engines that provide power for non-propulsion uses (i.e. lights, navigation, and other ship-board uses). The main engine primarily uses residual fuels such as

¹ State of California, Air Resources Board. “STAFF REPORT: INITIAL STATEMENT OF REASONS FOR PROPOSED RULEMAKING; PROPOSED REGULATION FOR AUXILIARY DIESEL ENGINES AND DIESEL-ELECTRIC ENGINES OPERATED ON OCEAN-GOING VESSELS WITHIN CALIFORNIA WATERS AND 24 NAUTICAL MILES OF THE CALIFORNIA BASELINE.” October 2005.
<http://www.arb.ca.gov/regact/marine2005/isor.pdf>

HFO, while the auxiliary engine runs on either HFO or marine distillate fuels such as MDO or MGO. Those vessels that use HFO in both their main and auxiliary engines are referred to as mono-fueled (or uni-fueled), while those vessels that use distillate fuels (MDO, MGO) and residual fuels (HFO) are dual-fueled.

As explained in the report, there are two types of fuels used in ocean going vessels, distillate and residual. The distillate fuels, MGO and MDO, are lower in sulfur content than the residual fuel, and as explained by the sponsor, the distillate fuels cost about twice as much. In general, the residual fuel has a higher sulfur content than the distillates and can be blended with a distillate to make an intermediate fuel oil (IFO). The residual fuel is so called because it is a fuel refined only after automobile, truck, and jet fuels have been refined. When demand or costs dictate, the residual fuel is further refined into petroleum coke, which can be used as an alternative energy source in some countries.

3. **What kind of information would the Board need to verify an exemption?** In order to verify the claimed exemption, the Board would need to know a few things about the fuel, the use of that fuel, the vessel, and where the vessel traveled. The bill currently provides that the water common carrier claiming the exemption would provide records, including, but not limited to, a log abstract or a cargo manifest. Would the Board be able to obtain the necessary information from the log abstract, cargo manifest, U.S. Coast Guard, and purchase orders? Would the Board need to know how many auxiliary engines are on the vessel, or if the vessel is mono-fueled or dual-fueled? How is the sulfur content of the marine fuel purchased in California verified or documented? How much fuel is burned while the vessel is dockside, maneuvering at ports and transiting at sea? The sponsor, PMSA, has been asked to explain the type of information the vessel owner/operator would be able to provide to substantiate a claimed exemption.
4. **Even if all of the information is provided to substantiate an exemption, this bill still presents a new and more complex challenge.** The current sales and use tax exemption for sales of fuel and petroleum products to water common carriers has been administered by the Board, on and off again, for almost twenty years. Although there are certain administrative sections consistent with current procedures, this bill would present a substantial change to the bunker fuel exemption and the Board's administrative functions. In general, the Board would be impacted to the extent and the timeframe that the industry responds to the incentives. Specifically, the proposed exemptions would add an additional workload and complexity in auditing, appeals, and regulatory functions of the Board.
5. **Technical issues.** The current sales tax exemption affects the sales of fuel and petroleum products to a water common carrier, for immediate shipment outside this state for consumption in the conduct of its business as a common carrier after the first out-of-state destination. In general, proposed Sections 6357.7 and 6357.8 both intend to provide an exemption for the immediate consumption of low-sulfur fuel products used by the water common carrier while in California waters or the lesser of 500 miles or until the first out-of-state destination. The bill should be amended in various subdivisions to maintain consistency with the idea that the new exemptions would cover immediate consumption, and not shipment of fuel. Board staff will work

with the author's office to address this issue as well as other issues, which include, but are not limited to, the following:

- There should be separate definitions for “low-sulfur fuel products” and “auxiliary engine” as used in proposed Section 6357.7. Section 6357.8 should also separately define “low-sulfur fuel products” and “main engine”.
- Are diesel electric systems used by cruise liners considered main or auxiliary engines? The large passenger cruise vessels use a system of diesel engines which are coupled to electric generators that provide electric power to electric motors. These electric motors are then coupled to the propeller drive shaft. This is in contrast to most other ocean going vessels that have a diesel engine that is directly coupled to the propellers.
- The repeal of Section 6357.7 is related to a Board finding that sales of low-sulfur fuels used in a vessel's auxiliary engine accounts for 95% of all sales of marine fuels to water common carriers for use in a vessel's auxiliary engine. Although the Board will be able to capture the exempt sales of low-sulfur fuel used in an auxiliary engine, it would be unable to determine what amount of “all sales” are used in an auxiliary engine. Those exempt sales under Section 6385 only require that the fuel be consumed after the first out-of-state destination. There is no requirement for the vessel to report, or for the Board to collect, information on fuel used in an auxiliary engine. This section should be amended to specify either a certain repeal date, or a report prepared by the appropriate agency related to the economic and/or the health impact that this measure has had on California. This approach may also be applicable to the repeal provisions specified in Section 6357.8, which are currently related to U.S. EPA actions.
- Marine fuels are distillate or residual fuels that do not meet the definition of “diesel fuel” as used in the Diesel Fuel Tax Law. Additionally, marine fuels are dyed and are not subject to the state excise tax on diesel fuels. As such, the Board recommends that Section 60510, as proposed to be added by this bill, be deleted. If there are other compliance or enforcement issues that the author intends to address, the Board will work with the author to draft appropriate language.

6. Related legislation. A number of bills have been introduced to provide a tax incentive for the purchase and use of environmentally-friendly products. AB 307 (Hayashi) would exempt from the sales and use tax a “fuel cell vehicle,” or a “fuel cell system” used exclusively for the purpose of upgrading a fuel cell vehicle, sold or leased to a “qualified person.”

AB 493 (Ruskin) would establish a clean vehicle incentive program that would provide one-time rebates to new motor vehicles that emit low amounts of greenhouse gases and impose surcharges for vehicles that emit large amounts of the same. The Board would be involved in collecting that surcharge and issuing rebates.

AB 1190 (Horton and Huffman) would establish a clean fuel incentive to encourage the distribution and sale of fuels that have lower emissions of greenhouse gases. The incentives would be offered in the form of “credits” for cleaner fuels to offset the

current fuel taxes, and provide a surcharge to be added to the current fuel taxes for fuels with greater greenhouse gas emissions.

SB 74 (Florez) would provide a sales and use tax exemption for a specified time for biodiesel fuel, and for tangible personal property purchased for use by a qualified person in the manufacturing, processing, or production of biodiesel fuel, as defined.

COST ESTIMATE

A detailed cost estimate is pending. However, some costs would be incurred in revising publications, regulations and the exemption certificate, notifying the affected parties, and carrying out compliance and audit activities to ensure proper reporting.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

This bill would establish the Clean Marine Fuels Tax Incentive Act and would provide a sales and use tax exemption to encourage the use of cleaner burning fuels than the bunker (residual) fuels currently used by ocean going common carriers. This would include vessels engaged, for compensation, in transporting persons or property in interstate or foreign commerce. This exemption is an incentive for the use of low-sulfur fuel products in the auxiliary and main engine.

Auxiliary Engines. In relation to auxiliary engines, *low-sulfur fuel products* is defined as any fuel, including heavy fuel oil, marine distillate fuels, marine gas oil, marine diesel oil, or any other diesel fuel, with a sulfur content of no greater than 0.05 percent, or 500 parts per million, that is purchased for use in the operation of an engine, on a vessel, that provides power for use other than propulsion. The product would be delivered directly into a vessel for consumption by that vessel while in California's territorial or internal waters.

Main Engines. In relation to main engines, *low-sulfur fuel products* is defined as any fuel, including heavy fuel oil, marine distillate fuels, marine gas oil, marine diesel oil, or any other diesel fuel, with a sulfur content of no greater than 1.5 percent, or 15,000 parts per million, that is purchased for use in the operation of an engine, on a vessel, that provides power for propulsion. The product would be delivered directly into a vessel for consumption by that vessel alone until the first out-of-state destination or 500 miles beyond California's territorial waters, whichever is less.

The Energy Information Administration (EIA) reports fuel sales data for vessel bunkering. In 2005, the following was reported for California:

- Distillate Fuel Oil 129 million gallons
- Residual Fuel Oil 1,412 million gallons

Distillate fuel generally refers to marine gas oil (MGO) or marine diesel oil (MDO) which is mainly used in auxiliary engines. Residual fuel refers to bunker fuel that is generally used in the main engines. According to PMSA, residual fuel has had a price range of \$300 to \$350 per metric ton and distillate fuels are priced from \$600 to \$700 per ton. It should be mentioned that bunker price quotes for ocean going vessels are always on a per metric ton basis.

The EIA data is in gallons and the price data provided is in metric tons. PMSA indicated that the conversion from gallon to metric ton depends on the fuel type and gravity, but generally the conversion will be between 280 and 300 gallons per metric ton.

The amount of distillate fuel sold in California, in metric tons, is estimated to be 444,828 metric ton (129 million gallons / 290 gallons per metric ton = 444,828 metric ton). If we assume the price to be \$650 per metric ton, sales are estimated to be \$289 million (444,828 metric ton × \$650 per ton = \$289 million).

The amount of residual fuel sold in California, in metric tons, is estimated to be 4,868,966 metric ton (1,412 million gallons / 290 gallons per metric ton = 4,868,966 metric ton). If we assume the price to be \$325 per ton, sales are estimated to be \$1.6 billion (4,868,966 metric ton × \$325 price per ton = \$1.6 billion).

The combined sales of distillate and residual fuel to water common carriers are estimated to be \$1.9 billion.

PMSA indicated that an estimated ratio of 12% of the fuel purchased in California would be consumed prior to the first out of state destination. If we apply this percentage to the \$1.9 billion in sales, then \$228 million in residual and distillate fuel sales is estimated to be related to consumption prior to the first out of state destination (12% × \$1.9 billion = \$228 million).

We have no information on what portion of these sales would be replaced by sales of low-sulfur fuel. PSMA indicated that currently no low-sulfur distillate fuel oil is used in vessel bunkering. We have been unable to find any data on the amount of low-sulfur residual fuel currently being used in vessel bunkering. It does, however, appear that the amount is small.

REVENUE SUMMARY

The immediate revenue impact of this bill would be small as at the present time very little low-sulfur fuel is being purchased for use in vessel bunkering.

However, if 10% of the current taxable purchases of fuel for vessel bunkering were to change to low-sulfur fuel, then the purchases exempted by this proposal would amount to \$22.8 million.

Revenue Effect

State loss (5.25%)	\$ 1.2 million
Local loss (2.00%)	0.5 million
Special District loss (1%)*	<u>0.2 million</u>
 Total	 <u>\$ 1.9 million</u>

* Nearly all of the bunker fuel is sold in jurisdictions with a tax rate of 8.25%.

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